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Economic Outlook

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

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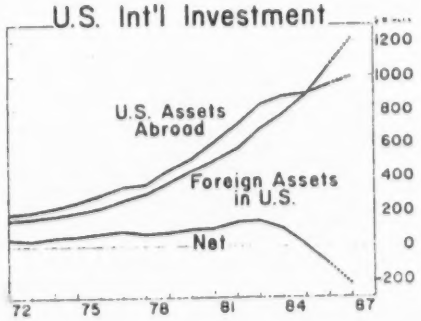
The dollar has occupied the economic center stage in recent weeks. Although the latest decline was no larger than previous episodes of dollar weakness, the fact that the decline occurred in spite of the G-7 agreement to stabilize the dollar has had a negative impact on market psychology. Foreign investors, faced with the prospect of further dollar depreciation and therefore further erosion in the value of their dollar portfolios, became reluctant to take on additional investments in dollar assets. This was a factor in the recent rise in U.S. interest rates. The resultant significant widening of the interest rate differential with foreign countries seems to have stabilized the dollar in recent trading. However, this stability is probably only a pause in the long-term downward trend.

As the following chart shows, as a result of our huge trade deficits in the last several years, the U.S. has now become the world's largest debtor country. Our net foreign debt was estimated at $200 billion at the end of 1986, twice as large as Brazil's. Our continuing large trade deficit plus net interest payments to foreign creditors suggest that our external debt will keep growing. It is estimated that by the end of this decade our net external debt will reach at least half a trillion dollars. Foreign creditors, who have already suffered huge losses due to the sharp depreciation of the dollar since early 1985, are unlikely to want to continue to increase their lending to us. The imbalance between our financing requirements and the willingness of foreign sources to lend to us strongly suggests that the dollar will have to fall further. The dollar may even become substantially undervalued before the downtrend is arrested. Even when the dollar falls to the level where our trade might eventually balance, our trade deficit will remain large because of the lag between exchange rate adjustment and trade improvement. As the financing gap will continue to exist, the dollar will likely overshoot and become undervalued.



Amid concerns for the dollar, signs of economic strength seem to have been overlooked. Real GNP expanded at an annual rate of 4.3% in the first quarter, the strongest performance since the economic slowdown began in mid-1984. As expected, almost all of the first quarter growth came from inventory buildup, while real final sales increased only 0.1%. The sharp rise in inventories in the first quarter seems to indicate that economic growth may slow down in the current quarter. Nonetheless, the deceleration is likely to be only moderate.

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The problem of inventory overhang is concentrated in the auto industry. Auto inventories rose sharply in the first quarter, while inventories in all other industries continued to be drawn down. This suggests that a reduction in auto inventories in the current quarter may be offset by inventory restocking in other industries. With the recent sharp rise in commodity prices and the resultant revival of inflationary psychology, it seems quite likely that those businesses whose inventories are not excessive currently will begin to restock in anticipation of future price increases.

Signs of accelerated inflation are becoming increasingly apparent. Commodity prices, both spot and future, have risen sharply in recent weeks. Producer prices increased at an annual rate of close to 5% in the first four months of this year, compared to a decline of 2.3% for all of 1986. The rise in import prices, excluding oil and food, continued to accelerate and reached 9.5% in the first quarter. One positive factor for the inflation outlook is that the rise in labor costs remains moderate. However, as the unemployment rate has dropped to 6.3%, close to the frictional level, the potential for a significant rise in wage costs cannot be overlooked.

Victor Kung

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
			1986	1987			1987	1988	1985-	1986-	1987-
	II	III	IV	I	II	III	IV	I	1986	1987	1988
Consumer Spending	4.0	4.4	-0.2	-0.3	2.2	2.0	1.7	1.3	2.6	1.4	1.5
Business Investment	-0.1	-0.3	0.4	-1.6	0.8	0.2	0.2	0.3	-0.1	-0.2	0.4
Residential Investment	0.6	0.5	0.3	-0.4	0.2	-0.2	-0.2	-0.1	0.5	0.0	0.0
Change in Inventories*	-2.9	-2.4	-0.4	4.2	-2.1	0.2	0.3	0.3	-0.2	0.2	0.0
Net Exports	-3.0	-1.0	1.6	1.5	0.6	0.9	0.9	0.5	-1.1	0.7	0.6
Government Purchases*	2.0	1.6	-0.6	0.9	0.8	0.5	0.5	0.5	0.8	0.7	0.5
Real GNP	0.6	2.8	1.1	4.3	2.5	3.6	3.4	2.8	2.5	2.8	3.0

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
			1986	1987			1987	1988	1985-	1986-	1987-
	II	III	IV	I	II	III	IV	I	1986	1987	1988
Nominal GNP	2.6	6.4	1.7	7.8	6.6	8.1	7.9	7.8	5.2	5.9	8.1
GNP Deflator	1.8	3.6	0.7	3.5	3.8	4.3	4.5	4.9	2.7	3.1	4.9
Corporate Profits After Tax#	1.7	1.9	3.7	15.3F	15.3	10.6	5.1	4.7	2.0	11.4	8.2

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Feb.	Mar.	Apr.	1986	1987	1988
Consumer Price Index** (%)	0.4	0.4	n.a.	1.1	5.1	6.0
Industrial Production (%)	0.4	-0.2	-0.4	1.0	2.5	3.5
Retail Sales (%)	4.8	0.8	0.1	5.5	4.5	5.8
Auto Sales (million units, a.r.)	9.9	10.1	10.5	11.5	10.5	10.0
Housing Starts (million units, a.r.)	1.83	1.75	1.70	1.81	1.71	1.62
Unemployment Rate (%)	6.7	6.6	6.3	7.0	6.3	5.9
Merchandise Trade Deficit ($ bn., a.r.)	-181.2	-163.2	n.a.	-166.3	-155.0	-135.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast